

LEGAL FRAMEWORK FOR OWNERSHIP OF MICROFINANCE BANKS AND THEIR SERVICES TO SMEs

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Abstract

The study examined the ownership structure of Microfinance Banks (MFBs) viz-a-viz their services to Small and Medium Enterprises (SMEs). Specially, the 'State' and 'Unit' Microfinance banks were examined. The study collected data from MFBs in Kaduna, Kano and Niger States. The data collected covered a five (5) year period from 2007 to 2011. The secondary data that were collected were analyzed to confirm the effects of ownership type of the MFBs on the services rendered to the SMEs. Both quantitative and qualitative data were collected by use of interview schedules, questionnaires and observation sheets. The results showed that in general the 'state wide' Microfinance banks performed better in terms of financial services offered to SMEs than the Unit Microfinance banks. This was further attributed to limited outreach service (that is, lack of branches) nature of the Unit Microfinance banks as well as lower capital structure and earning capacity. The study therefore recommended that special incentives be granted to the later to enhance their capacity to serve the SMEs.

Keywords: *Microfinance, Loans, Ownership, Licensing and Collateral*

Background to the Study

The rise of microfinance can be traced from the activities of state delivery of subsidized credit to poor farmers in the 1980s. Prior to this period, government agencies were the predominant method of providing productive credit to those with no previous access to credit facilities-people who have been forced to pay usurious interest rates or were subject to rent seeking behavior. Government and international donors assumed that the poor required cheap credit and saw this as a way of promoting agricultural production by small land owners. In addition to providing subsidized agricultural credit, donors set up credit unions (financial cooperative societies) with the aim of mobilizing savings in rural areas in an attempt to teach poor farmers how to save. However, from mid 1980s, the subsidized, targeted credit organizations supported by many donors was the object of steady criticism, because most programs accumulated large loan losses and required frequent recapitalization to continue operating. It became clear that market based solutions were required. This led to a new approach that considered microfinance as an integral part of the overall financial system. The emphasis now shifted from the rapid disbursement of subsidized loans to target populations towards the building of local, sustainable institutions to serve the poor.

As a result, local NGOs began to look for a more long-term approach than the unsustainable income generation approaches to community development. For instance, in Asia Dr. Muhammad Yunus of Bangladesh led the way to the formation of what is known as Grameen Bank. In Latin America, ACCION international supported the development of solidarity group lending to urban vendors and Foundation Carwajal developed a successful credit and training system of individual micro entrepreneurs. At the same time, formal financial sector witnessed changes as the case of Bank Rakyat Indonesia, a state owned, rural

bank, moved away from providing subsidized credit and took an institutional approach that operated on market principles. Since then, the field of microfinance has grown substantially with a focus in providing financial services only, whereas the 1970s and 80s were characterized by a package of credit and training which required subsidies. The growth heightened as micro finance NGOs are transforming into formal financial institutions that recognize the need to provide savings services to their clients and to access market funding sources rather than rely on donor funds (Ledgerwood, 2000).

Microfinance in Nigeria

Microfinance is about providing financial services to the poor that were hitherto not served by the conventional financial institutions. The outstanding features that distinguish microfinance from other formal financial institutions are: the smallness of loans advanced to customers in the absence of asset-based collateral and simplicity of operations.

In Nigeria, the formal financial system served a fraction of the economically active population (35%) while the larger part of it (65%) are excluded from access to financial services. The fractions are therefore served by the informal financial sector, through non-governmental organization-microfinance institutions (NGO-MFIs), money lenders, friends, relatives and credit unions. However, the non-regulation of these institutions has serious implications for the Central Bank of Nigeria (CBN) ability to exercise that aspect of its mandate of promoting monetary stability and a sound financial system. This therefore necessitate the formulation of a microfinance policy to enhance financial infrastructure of the country to meet the financial requirements of the micro, small and medium enterprises (MSMEs) to create a vibrant microfinance sub-sector that would be adequately integrated into the mainstream of the national financial system and provide the stimulus for growth and development. The policy also aimed at harmonizing operating standards and provide a strategic platform for the evolution of microfinance institutions, promote appropriate regulation, supervision and adoption of best practices. In general, the policy framework of microfinance in Nigeria is intended to promote an even spread of microfinance banks, their branches and activities, to serve the unserved but economically active clients in the rural and semi-urban areas (CBN, 2011).

Research Problem

A major problem faced by the SMEs is that of accessibility to credit. The specific objectives of the microfinance policy in Nigeria include making financial services accessible to a large segment of the potentially productive Nigerian population in the SMEs sector which otherwise would have little or no access to financial services (NDIC, 2010). It was observed that the MFBs tended to be risk averse as many of them kept large sums of money with the universal banks rather than giving such funds as loans. Some were even so risk averse to the extent that a large proportion of their funds were invested in treasury bills (NDIC, 2010).

The overall picture in 2010 revealed that 52% of their total assets to cash were placements with other conventional banks and investments in money market instruments while micro-loans accounted for an average of 28%. CBN (2010) also revealed that there are problems of weak capital base, high operational costs, scarcity of loanable funds and poor corporate governance practices. These mixed results call for investigation on the implications of the ownership structure of MFBs on their performances. This is even more so, when considered along the fact that no research study has been carried out on the implication of the legal framework for ownership of MFBs in Nigeria.

In an attempt to assess the impact of microfinance in Nigeria evidence has shown that there exist large percentage of prospective client to microfinance that were unserved, due largely to limited outreach of the desired target and insufficient capital and un-even spread of MFBs in the country, as well as un-conductive legal framework that guides the operations of MFBs. While poverty and inflation rate in the country remains high at 67.1 percent and 10.8 percent respectively. In the same vein the GDP growth rate shows no significant impact as it stood at 7.3 percent (NBS, 2013).

Research Objectives

1. To investigate whether the 'state' microfinance banks perform well in terms of rendering financial and other services to SMEs.
2. To determine if unit microfinance banks in Nigeria have the needed capacity to provide effective outreach services to SMEs.

Conceptual Issues

Micro-finance refers to the provision of financial services to SMEs and other low income clients (Ledgerwood 1999). Financial services generally include savings mobilization and the granting of credit. However, some microfinance organizations also provide insurance and payment service in addition to the provision of social services. Some Microfinance Institutions (MFIs) are also engaged in social intermediation services such as training in accounting and book-keeping functions and general financial management. Therefore, the meaning of microfinance usually include both financial and social intermediations.

The concept of a formal micro-finance in Nigeria dates back to 1990 when the then military administration of Babangida introduced the concept of community banking in the Nigerian financial system (Aliu 1994). The fundamental concept of a community bank is that of a self sustaining financial institution, owned and managed by a community or group of communities for the purpose of providing credit, deposit, banking and other financial services, to its members, largely on the basis of their self-recognition and credit worthiness. This is in contradistinction to the near total reliance by the orthodox banks on viable collateral as the basis for giving credit.

The creation of microfinance banks in 2005 marks the beginning of the transformation of Community Banks (CBs) to Microfinance Banks (MFBs) in Nigeria. Today, there are three categories of Microfinance Banks namely:

- i. **Unit Microfinance Bank:** Authorized to operate in only one location. It is required to have a minimum paid-up capital of N20 million and is prohibited from operating branches or cash centres.
- ii. **State Microfinance Bank:** Authorized to operate in one state or the Federal Capital Territory (FCT). The minimum paid up capital requirement is N100 million and is allowed to open branches within the same state or the FCT. It can also operate branch or cash centre.
- iii. **National Microfinance Bank:** This is authorized to operate in more than one state including the FCT. The minimum paid-up capital requirement is N26 billion. It can also open branches in all the states and the FCT and can operate branch or cash centre.

Microfinance banks in Nigeria are prohibited from engaging in foreign exchange or related transactions. They are also not allowed to participate in cheques clearing activities (including collection of third party instruments for clearing through correspondent banks). They are also not allowed to deal in land or real estate for speculative purposes.

Loans: Lending to small businesses is an essential function of micro-finance banks. Lending has become a vital function in microfinance banking because of its direct effect on the economic growth through productive activities and the general business development of the SMEs which the bank serves. In conventional banking, term loans are usually loans with maturities exceeding one year. Traditionally, significant innovations in term loans have been introduced to meet specific needs of target customers-such as repayments in level amount over the period of the loan. In Nigerian microfinance banking, a loan is granted to the operators of small and micro-enterprises, peasant farmers, artisans, fisherman, youth, women in both the formal and informal sector. The loans are mostly unsecured, but typically granted on the basis of the applicant character and combined cash flow of the business (CBN-revised regulatory and supervisory guidelines for MFBs, 2012).

In line with the Central Bank of Nigeria (CBN 2012) requirement, the tenure of micro finance loans is usually within 180 days (60 months) tenure. Longer period than six (6) months would be treated as special cases. In the case of agriculture, or projects with longer gestation period, a maximum tenure of twelve (12) months is permissible, and in housing microfinance, a longer tenure of twenty-four (24) months is permissible. The CBN guideline (2012) also stipulates that the maximum principal amount shall not exceed N500,000 or one (1) percent of the shareholders fund unimpaired by losses. Microfinance loans may also required joint and several guarantees of one or more persons. The repayment can be in accordance with the amortization schedule or daily/weekly or monthly installments.

Ownership and Licensing: Although effective regulation and supervision by regulatory bodies are important to the health of the financial system, no amount of external oversight can be replace accountability that stems from proper governance and supervision performed by the owners of financial institutions (Churchill and Craig 1994). In Nigeria, a microfinance bank can be established by individuals, group of individuals, community development associations, private corporate entities and foreign investors (Sanusi 2010). The CBN revised regulatory guideline for MFBs in Nigeria (2012) failed to specified the maximum number of shares that an individual or groups can own in MFBs.

However the guideline does provide that no individual, group of individuals, their proxies or corporate entities shall own interest in more than one MFB, except as otherwise approval by the CBN. CBN (2012) explained the licensing requirements for three (3) categories of MFBs as 'unit', 'state' and 'national' microfinance banks each with different capital requirements as earlier explained. Berle and Means (1932) set forth that ownership dispersion implies management is distinguished from ownership, which, as Jensen and Mecking (1976) emphasized, may contribute to agency problems between managers and shareholders or shareholders and debtors on the other hand, Shleifer and Vishny (1986) detest the phenomenon of ownership concentration. This may well lead to the conception of ultimate controller which can result in embezzlement and other agency problems (Claessens, Djankov, Fan and Lang, 2002).

Literature Review

The existing literature offers a number of possible ownership structures that can be attributed to MFIs in different parts of world. As the MFIs grow, the issue of ownership becomes apparent. This is particularly important as the MFIs begin to create a more formalized structure that is, change from being an NGO into a formal financial institution. Owners of formalized MFIs can generally be divided into four categories.

- i. Non-governmental organizations (NGOs) MFIs:** In this type of microfinance NGOs have no owners per se, as it does not generally have shareholders; rather management usually elects the board members. Furthermore, NGO board members do not usually fulfill the board's fiduciary role by assuming responsibility for the institution's financial resources especially those provided by donors (Otero, 1998).
- ii. Private Investors MFI Ownership:** These are privately owned institutions with the existence of shareholders who elect board of directors to oversee and fulfill the fiduciary role on behalf of the owners. Return on investment is a major concern to investors thereby ensuring capital preservation which enhances sustainability of operations.
- iii. Public Entities MFIs:** These are institutions established by government or its agency. The motive behind promoting this type of institution is political and social.
- iv. Specialized Equity Funds:** These are fund provided by private organizations and international financial organization to setup an MFI, commanding large part of the equity share.

Effect of Ownership Structure on Microfinance

1. Microfinance Operated by NGO: NGOs microfinance being a donor base institution source funds to finance loan portfolios from donor funding or concessional funds. However, NGO amongst other forms of microfinance institutions offered the smallest loans sizes and relatively more social services than banks, savings banks or credit unions. As a result, it is argued that NGOs should not own MFIs unless they are operated separately and the only financial link is ownership (Barenbach and Churchill, 1997). Furthermore, a part of operation of an NGO and other informal MFIs is that they mostly operate outside the structure of government regulations and supervision; often they do not comply with common book-keeping standards and are not reflected in official statistics of the national financial sector. Having concentration on the informal sector on loans and deposits for small firms and households. Often loans are granted without formal collateral but on the basis of familiarity with the borrower, social sanctions substitute for legal enforcement, as well as the total amount lent and the number of frequency of installments, is fitted to the borrower's expected cash flow; little if any paperwork is involved in applying for loan (Krahnhen and Schmidt 1994, 32). These problems have culminated to the collapse of most NGOs, MFIs.

2. Public Ownership of MFIs: Depending on their approach, government run microfinance programmes can either contribute to or be detrimental to successful microfinance activities. Usually, government microfinance programmes are often perceived as social welfare, as opposed to economic development efforts. Some people argued that government should provide financial services to micro entrepreneurs but must do so on a commercial basis to provide continued access to microfinance and to avoid distorting the financial markets (Stearns and Otero, 1990).

However, despite these negative experiences, there exist certain benefits that are derived from government involvement in microfinance. This includes the capacity to disseminate the programme widely and obtain political support, the ability to address broader policy and regulatory concerns and the capacity to obtain a significant amount of funds. An example of a successive state bank is the Bank Rakyat Indonesia, a profitable state bank in Indonesia that serves low income client (Yaron, Benjamin and Piprek, 1997).

3. **Private Ownership of MFIs**

In private ownership type MFIs are often indigenous groups or NGOs operated by local leaders in their communities. They are frequently supported by international donors and international NGOs that provide technical assistance or funding, particularly in the start up phase. Some private MFIs still subsidize interest rate or deliver subsidized services. Others create self sufficient operations and rely less and less on external donor funds. A few MFIs now begin to access funding through commercial banks and international money markets (Ledgerwood, 2000).

Private microfinance institutions need to be regulated for it to be effective in operation. Financial regulations refer to the body of principles, rules, standards and compliance procedures that apply to financial institutions (Ledgerwood, 2000). However, most private MFIs are significantly different from commercial banks in institutional structure. Furthermore, managing a microloan portfolio differs in important ways from managing a conventional bank portfolio. MFIs and microloan portfolios cannot be safely funded with commercial source especially public deposits, unless appropriate regulation and supervisions regimes are developed (Ledgerwood, 2000).

Nigeria's MFBS Ownership Structure

In Nigeria, the ownership structure for MFBS is stipulated by the CBN in the microfinance banks policy review (2011), that a microfinance bank may be established by individuals, group of individuals, community development associations, private corporate entities and foreign investors. But the policy prohibited an individual, group of individuals, their proxies or corporate entities and/or their subsidiaries from owning controlling interest in more than one MFB, except as approved by the CBN.

There are three categories of MFBS that are approved by the CBN. These are: unit microfinance bank, state microfinance bank; and national micro finance bank. The unit microfinance bank (UMFB) is required to raise a minimum paid-up capital of N20 million and is prohibited from having branches and/or cash centers. The bank is therefore authorized to operate any in one location.

On the other hand, a state microfinance bank is authorized to operate in one state or the federal capital territory. It shall be required to have a minimum paid-up capital of N100 million and is allowed to open branches within the same or the FCT, subject to prior written approval of the CBN for each new branch or cash center. The last category is authorized to operate in more than one state, including the FCT. It is required to have a minimum paid-up capital of N2 billion and is allowed to open branches in all states of the federation and the FCT, subject to prior written approval of the CBN for each new branch or cash center.

Theoretical Framework

The paper based its analysis on the Keynesian theory of money. Keynes believe in the existence of unemployment equilibrium in an economy. This implies that an increase in money supply can bring about permanent increase in the level of output. When the quantity of money is increased, its first impact is on the rate of interest which tends to fall. Given the marginal efficiency of capital, a fall in the rate of interest will increase the volume of investment. The increased investment will raise effective demand through multiplier effect thereby increasing income, output and employment (Jhingan, 2008).

Methodology

Content analysis was used to analyse data in this study. This technique is equally suitable to study the level of achievement of MFBs on service delivery to SMEs base on their ownership structure. Thus, data were generated both from primary and secondary sources. The data being qualitative in nature were used to determine the level of achievement. A predetermined index of scores were assigned to each level of achievement in percentage terms. The impact of the legal framework of MFBs ownership structure of unit microfinance banks (UMFB) and state microfinance banks (SMFB's) with the achievement variables denoted as V. the achievement on each variable by each type of MFB's was scored accordingly. The index of 1 was coded to each achievement variable and 0 to non achievement of a variable. The total index scored was compared with the expected index score of 7 (having seven achievement variables).

Decision Rule

The decision rule for this technique is by assigning non-achievement, minimum achievement, high achievement and maximum achievement determined by the percentage score of index achievement compared with one determined percentage ranges between 0-25 percentage, 26-50 percent, 51-75 percent and 76-100 percent respectively. The percentages are arrived at by taking the ratio of computed achievement index and expected achievement multiplied by 100.

Where V1, V2, V3, ... V7 are representatives of the following achievement factors:

- V1 = Provision of financial services to SMEs
- V2 = Enhance productive activity in SMEs sector
- V3 = Improving economic status of SMEs operators
- V4 = Promotion and emergence of an effective and integrated financial system that response to the needs of SMEs
- V5 = Inculcate of discipline banking habit among SMEs operators in Nigeria
- V6 = Fostering of spirit of common ownership and use of economic assets and maintenance of facilities
- V7 = Enhancing SMEs ability to create employment opportunities

Analysis Table

Microfinance bank type	Achievement variable V1, V2, V3, V4, V5, V6, V7,	Component Achievement	Expected Achievement	Percentage
Unit microfinance bank	1 1 0 1 0 0 0	3	7	42.86
State microfinance bank	1 1 1 1 0 1 1	6	7	85.71
Computed	2 2 1 2 0 1 1			
Expected	2 2 2 2 2 2 2			
Percentage	100 100 50 100 0 50 50			

Result Interpretation and Findings

From the result analyzed, it shows that in general state MFBs attains maximum level of service achievement to SMEs comparing the percentage index score of 85.71 falling within the 76-100 per cent range mark-up as maximum achievement decision rules; as against a 42.86 per cent which indicate a minimal achievement by Unit MFBs located in the three areas of study. For a one to one variable achievement, the analysis reveals that there are successes in V1, V2, and V4, recorded to both types of banks. While V5 has no record of success in either of the banks which can be explained as a result of limited outreach to target clients, and for V3, V6 and V7 only the SMFB record achievement indicating an overall 50 per cent achievement on each of the variables.

Discussion of Findings

From the analysis in the preceding section, it is clear that the SMFBs performed better than the Unit Microfinance Banks (UMFBs). This can be attributed to the fact that the SMFBs have greater ownership and operational spread than the UMFBs in Nigeria. However, the primary objective of MFBs—micro loans—are feasibly extended by both types of banks, thereby enhancing the productive activities of SMEs. Furthermore, as both UMFBs and SMFBs are under the purview of the financial authority, this enhances the synergy of micro-credit units with other financial intermediaries within the financial system. This has improved the performance and regulatory activities of the financial sector; on the contrary evidence from the findings indicate that SMEs operators are yet to inculcate a full banking habit as a result of limited outreach of MFBs in terms of their limited number. Other factors are high interest rates, poor economic conditions and inadequate provision of infrastructural facilities which have negatively affected the SMEs operations.

Conclusion

Based on the foregoing findings it is imperative to conclude that a unit microfinance bank performs below expectation when compared to the state microfinance banks. Despite the appreciable levels of success recorded by MFBs in their outreach services, large percentage of SMEs and micro-entrepreneurs still remained unserved.

Recommendations

- (1) Due to diversity found in microfinance sector in institutional type, scale of operations and level of professionalism, it becomes necessary to apply flexible regulatory mechanism. This will allow the variety institutional type of MFIs to operate in a conducive manner.
- (2) To prevent MFBs from insolvency regulatory authority must ensure that capital adequacy is maintained by MFIs.
- (3) To augment the above recommendation, minimum capital requirement for each type of MFB must be met for it to operate. However, this minimum capital standard must be set in accordance with the objectives of encouraging competition and lowering the risk of MFBs.
- (4) To make MFBs more effective, it is important to minimize the level of liquidity risk. This can be achieved by accessing relatively cheap commercial capital allocation or special grants to those MFIs that maintaining high operational standards.
- (5) The banks should provide loan repayment incentives by scheduling repayment to match the fluctuating income sources of some of the SMEs. This will reduce delinquencies.

- (6) A separate regulatory body should be established for the MFBs to ensure proper supervision and control.
- (7) No individual should be allowed to hold a controlling interest (share) in a microfinance bank.
- (8) The maximum number of share to be owned by an individual should not exceed 5%. This will eliminate problem of dominant ownership of an MFB by a single or few individuals. Share ownership by associations in terms of numbers should be specified.

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